

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Houston Analyst: Victoria Favorito Bill Number: AB 897
Related Bills: See Legislative History Telephone: 845-3825 Amended Date: March 29, 2007
Attorney: Pat Kusiak Sponsor: _____

SUBJECT: Exempt Organizations/Exempt From State Taxes Upon Submission Of Notification Issued By IRS Approving Tax Exempt Status

SUMMARY

This bill would eliminate the requirements for certain federally tax-exempt entities to apply for state tax exemption.

SUMMARY OF AMENDMENTS

The bill as introduced on February 22, 2007, amended provisions relating to the California tax-exempt application process for nonprofit organizations.

The March 29, 2007, amendments removed the bill's original provisions and replaced them with new provisions that would eliminate the tax-exempt application process for Internal Revenue Code (IRC) section 501(c)(3) organizations that submit an IRS determination letter granting exemption to the Franchise Tax Board (FTB).

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to remove the duplicative qualification process for obtaining a tax-exempt status by allowing entities that are tax-exempt under federal law to also be treated as tax-exempt for state purposes.

EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2008, and would be operative on and after that date.

POSITION

Pending.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Selvi Stanislaus

3/29/07

ANALYSIS

FEDERAL/STATE LAW

Federal Law

Under the IRC, certain entities are treated as tax-exempt organizations. A tax-exempt organization can be a trust, unincorporated association, or nonprofit corporation.

The terms “nonprofit” and “tax-exempt” have different meanings. Nonprofit status is a matter of State law, which governs the organization and creation of the entity. All tax-exempt organizations are nonprofit, but not all nonprofits are tax-exempt.

Tax-exempt status is conferred for purposes of exemption from tax. IRC section 501(c)(3) organizations make up the largest category of tax-exempt entities. They are organized and operated for one or more of the following purposes:

1. Charitable
2. Educational
3. Religious
4. Scientific
5. Literary
6. Testing for public safety
7. Fostering national or international amateur sports competition
8. Preventing cruelty to children or animals

To qualify for exempt status with the IRS, an IRC section 501(c)(3) organization must be organized under state law as a corporation, community chest, fund, or foundation. Churches, conventions, or associations of churches, and any organization (other than a private foundation) normally having annual gross receipts of less than \$5,000 annually, are exempt automatically if they meet the requirements of IRC section 501(c)(3). Organizations that are not automatically exempt by federal law must apply for tax-exempt status for federal purposes by submitting an application to the IRS with accompanying statements showing that all of the following are true:

- The organization is organized exclusively for, and will be operated exclusively for, one or more of the purposes (e.g., charitable, religious) specified above.
- No part of the organization’s net earnings will inure to the benefit of private shareholders or individuals.
- The organization will not, as a substantial part of its activities, attempt to influence legislation (unless it elects to come under the provisions allowing certain lobbying expenditures) or participate to any extent in a political campaign for or against any candidate for public office.

The IRS requires all applications for tax-exempt status to be accompanied by a copy of the organization’s Articles of Incorporation or other document creating the organization.

The Articles of Incorporation must limit the organization’s purposes to one or more of the exempt purposes listed in IRC section 501(c)(3) and declares the assets of an organization permanently dedicated to an exempt purpose.

The IRS also requires that copies of financial statements be submitted with the application.

Federal law requires the payment of a user fee when making a request for determination of exempt status. For organizations with annual gross receipts in excess of \$10,000 annually over a 4-year period the fee is \$750 and for those with annual gross receipts of less than \$10,000 the fee is \$300. A ruling or determination letter will be issued to the organization if its application and supporting documents establish that it meets the particular requirements of the IRC section under which it is claiming exemption.

State Law

Although most California laws dealing with tax exemptions are patterned after the IRC, obtaining state tax exemption is a separate process from obtaining federal exemption. In order to obtain state exemption from tax, an organization must: (1) submit a completed exemption application form to the FTB, (2) pay a filing fee of \$25, and (3) receive a letter issued by FTB exempting the organization from tax. The exemption application is required to include the Articles of Incorporation, the by-laws of the organization, and financial statements showing assets, liabilities, receipts, and disbursements.

To be exempt from taxation, the organization must be organized and operated for one or more exempt purposes listed in the California Corporation Tax Law (CTL). The exempt purposes for California exemption are the same as those listed in the Current Federal Law section of this analysis except that churches and small charities are not automatically exempt under state law; they must apply for state tax exemption.

THIS BILL

This bill would allow 501(c)(3) organizations that are granted tax-exempt status under federal law to submit a copy of the IRS issued tax-exempt status notice to FTB to establish their state exemption.

As a result, 501(c)(3) organizations that receive tax-exempt status with the IRS, would no longer be required to file an exemption application with FTB or submit a \$25 filing fee.

These organizations would continue to receive a letter issued by FTB verifying the organization's exemption from state tax. Those organizations that are not issued a federal determination letter would still file an application for California exemption.

This bill would specify that FTB would not be prevented from revoking tax-exempt status if the entity fails to meet certain state provisions governing exempt organizations.

PROGRAM BACKGROUND

The department receives approximately 7,000 requests for tax-exempt status determinations annually. Of these requests, 10% on average are rejected as a result of failing to include all required documentation or failing to meet the requirements of the provisions that allow exemption. The department regularly provides determinations prior to the IRS making its determination since the majority of these organizations are new and tend to lack the user fees required to file the federal application. Also, while churches and other nonprofits are not required to receive federal tax-exempt status, they are required to apply for state exemption.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department.

TECHNICAL CONSIDERATIONS

Amendment 1 has been provided to offer consistent terminology with current law.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

The franchise tax regulations for *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* provide a presumption that a corporation exempt from tax under federal law will also be exempt from their state franchise tax.

FISCAL IMPACT

To the extent that this bill would reduce the amount of determination letters issued by department staff, it would generate a cost savings. The cost savings have not been determined at this time, but will be developed as the bill moves through the legislative process.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses.

Estimated Revenue Impact of AB 897 Operative for Tax Years BOA 1/1/2008 Assumed Enactment Date After 6/30/2007		
2007/08	2008/09	2009/10
<-\$150,000	<-\$150,000	<-\$150,000

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue impact from this bill would be due to the decrease in application fees collected by FTB, plus the decrease in franchise/income/minimum taxes paid by IRC section 501(c)(3) organizations denied exempt status by FTB based on the organizations' applications for tax-exempt status.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 897
As Amended March 29, 2007

AMENDMENT 1

On page 2, line 20, strikeout "not operated" and insert:
not organized and operated